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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Magalie Roman Salas
Secretary
Federal Communications Commission
Room TW-A325
445 Twelfth Street, N.W.
Washington, D.C. 20554

Re: InterCarrier Compensation for ISP Bound Traffic,
CC Docket No. 99-68

Dear Ms. Salas:

On October 26, Qwest filed an ex parte with the Commission attaching a paper prepared by Dr. Taylor of National Economic Research Associates. Dr. Taylor purports to demonstrate economic inefficiencies inherent in the existing compensation arrangement involving the payment by ILECs of reciprocal compensation to CLECs for terminating calls from ILEC customers to ISPs served by the CLECs.

We write on behalf of Focal Communications Corporation to bring to the Commission's attention a recent decision by an Administrative Law Judge at the California Public Utility Commission.[1] In that decision, which is attached, the ALJ after a full hearing, ruled on many of the arguments premised on economic theories presented in the Qwest ex parte by Dr. Taylor, and, based on the record, dismissed them as without merit.

The California decision is the result of a generic rulemaking proceeding in which the California Public Utility Commission undertook to examine the appropriate compensation mechanism for the termination of calls to ISPs. The CPUC had previously determined that reciprocal compensation should be paid for the termination of calls to ISPs, as with all other local calls. This proceeding was initiated February 3, 2000 and has been active for 10 months. Unlike the arguments in the Qwest ex parte, the testimony in the California proceeding was subject to cross-examination. The ALJ presided over evidentiary hearings from August 14-29. Based on a fully developed record,[2] the ALJ decided that there was no evidence that the payment of reciprocal compensation for ISP traffic will impair incentives for LECs to compete in an economically efficient manner.

[1] Order Instituting Rulemaking on the Commission's Own Motion Into Reciprocal Compensation for Telephone Traffic Transmitted to Internet Service Providers, Proposed Decision of ALJ Pulsifer (11/3/00).

[2] The hearing transcript is 1898 pages. Over 170 exhibits were introduced. (p. 9)

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In fact, he found that the elimination of reciprocal compensation for calls to ISPs would be anticompetitive and discriminatory. The ALJ, recognizing economic reality, noted that the end result of the application of the ILEC theories would be a lessening of choice for ISPs and a likely increase in price to ISP users At bottom, the ALJ found the record did not provide any justification for treating calls to ISPs differently than local calls to other end users.

The Elimination of Reciprocal Compensation Would Be Anticompetitive

In the decision, the ALJ addressed an issue notably absent from the ILEC presentation; namely, the impact of their proposal on competition. The ALJ found that the elimination of reciprocal compensation "would trigger undesirable consequences that would not be conducive to competition." (p. 30) He determined that the elimination of reciprocal compensation could leave CLECs with the choice of either raising rates to ISPs (the ILEC proposal) or curtailing their service to ISPs, leaving the market to ILECs (the ILEC goal). With CLECs driven from the market, the ALJ recognized the very real possibility that ILECs would favor their own ISP affiliates. "In the event of inferior services from ILECs, ISPs would have less recourse to seek competitive alternatives." Recognizing an economic reality that appears to elude the ILECs in their rhetorical zeal, the ALJ found that "CLECs loss of reciprocal compensation revenue could also lead to higher telephone charges to ISPs . . . [and] subscribers of ISPs . . . would face the prospect of potentially higher ISP subscription fees, or per minute of use charges." (p. 30)

Cost Causation

Dr. Taylor to a large extent premised his arguments on his theory that the ISP is the "cost causer"-- in effect the author of the economic decision that gave rise to the costs. To demonstrate his theory, Dr. Taylor argues that without the ISPs "there would be no Internet-based calls, and no cost would be caused for such calls." (Taylor October, p. 4) While we certainly don't argue with that truism, it is obviously not the point. There is an Internet, there are ISPs, including those owned by the BOCs, and BOC end users make calls to ISPs to obtain information. ISPs are not "passive participants in the process" (Taylor Oct., p. 5). In fact, in many cases, the BOC end users' calls go nowhere other than to the ISP. Information is stored by the ISP on its servers, other information is cached and the ISP makes it directly available to the BOC end user. Dr. Taylor's analogy of the long distance call simply does not hold up. (Taylor, October 4-5). While the IXC in Dr. Taylor's example may be a "passive participant," the ISP is demonstrably much more than that. Even the BOCs recognize that ISPs provide information service, a term defined in the 1996 Act which necessarily involves more than passive involvement (Section 3 (2)). In response to the same cost causation argument espoused by Dr. Taylor, the ALJ found the theory "inconsistent with the principles linking payment obligation with cost causation for other types of calls. The BOC witness Dr. Harris sought to qualify the inconsistency by claiming that a unique relationship exists between the ISP and its subscriber in comparison to other types of 'true local calls.'" The ALJ found "no essential difference between the ISP and its subscriber that justifies an inconsistent application of cost causation principles compared with other types of calls." (p. 86) As the ALJ noted, the relationship between a CLEC or BOC and various customers bear the same characteristics of the end user and of the ISP provider. "There are a number of non-ISP businesses and service providers for which the telephone call placed by the customer is an indispensable aspect of the transaction with the end user." Examples of such relationships include a call answering bureau, a customer service center or a travel reservation bureau. In each case "the ultimate goal is not to speak to the called party as [an] end in itself, but rather to obtain information." (p. 87) The fact that in each of these cases the called party may have solicited the call does not change the underlying relationship between the end user and its ILEC. The ALJ concluded "where the ILEC originates a call on behalf of its subscriber, whether the purpose of the call is to reach an ISP, or travel reservations bureau, or a personal friend, the cost causation principles should be applied consistently." (p. 87) Historically, local rates are set based on the sent paid approach. Dr. Taylor would turn this on its head and have the called party pay. The BOCs have provided no meaningful support for this dramatic change in rate making policy.

Dr. Taylor asserts that current reciprocal compensation policies create arbitrage opportunities because rates are not set at the CLECs' costs of transport and termination (Taylor 12-13). Faced with the same complaint in California, the ALJ dismissed, as being without any basis in the record, the ILEC assertion that the CPUC reciprocal compensation policy "merely creates an incentive for a CLEC to sign up ISPs for the purpose of arbitraging 'windfall' profits." The ALJ noted what should be obvious, namely, that "to the extent that certain CLECs have a financial incentive to sign up ISPs, the CLECs are not simply arbitraging profits, but provide a legitimate service to the customers of ILECs by delivering their calls to ISPs." (p. 29) A windfall, he noted, "implies an unearned profit advantage . . . at the expense of the ILEC." In order to reach that conclusion, the ALJ reasoned they "would have to find that a CLEC collects the funds without performing a commensurate function or service to benefit the ILEC or its customers." (p. 47) The ALJ found that quite to the contrary, it was clear that the CLECs perform a necessary function, which in the absence of the CLEC, the ILEC would be required to assume.

The ALJ rejected arguments similar to Dr. Taylor's assertions that applying reciprocal compensation to calls to an ISP is failed public policy and an incentive for economic inefficiency. In fact, in the ALJ's view, reciprocal compensation actually provides ILECs with an economic incentive to achieve cost savings and efficiencies. The payments should also incent what one would consider natural outside a monopoly environment, namely, aggressive competition for ISP customers. (p. 78) As the ALJ concluded, the fact that CLECs have been aggressive in marketing to ISPs and have as a result a higher than anticipated share of the ISP market "does not justify insulating the ILECs against the risk resulting from such an unexpected outcome." (p. 78) Rather than rewarding and incenting CLECs to develop efficiencies, Dr. Taylor seeks to impose asymmetric rates, ensuring the BOCs of full recovery of their costs, efficient or not. (Taylor, Oct 10-12) Those times have passed.

Cost Differences: Network Design

Dr. Taylor argues that CLEC network costs are lower and therefore their reciprocal compensation rates should be lower. As an example, Dr. Taylor, like Dr. Harris, argued that the use of ISDN, PRI facilities circuits to service ISPs avoids congestion, switching and rationing costs and accordingly, those costs should not be included since they "do not vary with additional uses and are therefore not incremental costs of delivering ISP band traffic." (Taylor at 8).

After examining the testimony and presiding at the hearings, the ALJ concluded that there is no basis to conclude that CLECs avoid traffic sensitive switching costs merely because of "dedicated" capacity used by ISPs. "While we recognize that ISP call terminations may be provisioned over ISDN PRI circuits which utilize higher line concentration than voice traffic, we find that the use of such circuits is not unique to ISPs. Moreover, we find no basis to distinguish the use of switching resources used by ISDN circuits from other circuits." (pp. 68-69) Regardless of the concentration levels to which ISDN PRI is engineered, ISDN circuits are allocated switching resources as calls are made. "We conclude that ISDN-PRI services, regardless of concentration ratios, use traffic sensitive switch resources (i.e., internal transport links, time slot management revenues and switch processing time) and incur related costs." The ALJ found an "insufficient basis to find that CLECs incur lower traffic sensitive termination costs as a result of line concentration differences that apply only to ISPs." (p. 69).

While accepting that certain other differences in network costs exist, the ALJ noted that the relevant inquiry was not whether the networks are different but "whether the CLECs' network differences cause significantly lower traffic sensitive terminating switching and transport costs of the type recoverable by reciprocal compensation." (p. 51) "We conclude that while the differences in network design configurations ... may result in various differences in costs, those differences generally do not relate to the traffic sensitive terminating transport and switching costs that are the subject of reciprocal compensation. Rather they relate to the non-traffic sensitive costs that are already recovered from end users." (p. 51) The ALJ found that there is "no necessity that CLEC costs must equal exactly the ILEC costs in every respect to justify the payment of reciprocal compensation for ISP calls." (p. 45) The ALJ recognized that if the CLEC is able to terminate ISP bound calls at a cost below the TELRIC rate, that, in itself, is no basis to conclude that the CLEC is earning a windfall.

Cost Differences: Call Characteristics

Dr. Taylor persists in comparing the cost of terminating a voice call to terminating a call to an ISP and faults CLECs for not recognizing this as appropriate. (Taylor 7, 10, 13) In response to the ILECs' argument in California that calls to ISPs have some different characteristics from voice calls, the ALJ concluded "that difference, in itself, doesn't justify excluding ISP calls from reciprocal compensation." (p. 46) The ALJ noted that the voice vs. ISP analysis was a major flaw in the ILEC argument. The ALJ points out that "the ILECs . . . fail to definitively compare ISP calls with other data-related or other specialized business-related calls." (p. 46) "It would be arbitrary to single out ISP calls as having a longer duration without noting that various other categories of local calls also can have similarly long deviations in comparison to voice calls." (p. 57)[3] In fact, the ALJ noted that "if ISP calls were earmarked for disparate treatment from all other local calls, we would also need to consider whether such treatment constituted a form of unfair discrimination." (p. 46)

Bill and Keep

The ALJ also examined the ILECs' proposal to apply bill and keep to ISP bound calls and found it wanting. The ALJ found that bill and keep is not an equitable alternative to reciprocal compensation. "The bill-and-keep alternative would create a significant asymmetrical distortion between (1) the service rendered in terminating ISP calls, and (2) the payments made for the service." (p. 85) The ALJ noted that even if the FCC rule prohibiting the use of bill and keep when there is a traffic imbalance is limited to "local calls," the ILECs provide no rationale why it would be inappropriate to use the same rationale with respect to calls to ISPs. (p. 86).

Conclusion

Examining the record developed in a fully litigated proceeding, ALJ Pulsifer has considered and rejected the litany of economic theories espoused by the ILECs. Peeling away their continued distaste for competition, ALJ Pulsifer found the ILEC arguments without merit, likely to lead to anti-competitive results and discriminatory treatment among types of customers. Calls to ISPs are similar to other local calls and should be subject to reciprocal compensation to compensate CLECs for real costs incurred by CLECs and avoided by ILECs.

Sincerely,

Richard M. Rindler

cc: Dorothy Attwood
Tamara Preiss
Jane Jackson
Adam Chaneub
Rodney McDonald
Christopher Wright
Jonathan Nuechterlein

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[3] The ALJ similarly rejected efforts to single out calls to ISPs on the basis of higher call completion rates (p. 59), trunk to trunk switching (p. 61), use of ISDNs PRI (p. 68).

Decision PROPOSED DECISION OF ALJ PULSIFER (Mailed 11/3/2000)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's Own Motion into Reciprocal Compensation for Telephone Traffic Transmitted to Internet Services Providers Modems.	Rulemaking 00-02-005 (Filed February 3, 2000)

(See Appendix A for List of Appearances.)